New York
Menlo Park
Washington DC
São Paulo
London
Paris
Madrid
Tokyo
Beijing
Hong Kong

Davis Polk

Linda Chatman Thomsen

Davis Polk & Wardwell LLP
901 15th Street, N.W.
Washington, DC 20005
202 962 7125 tel
202 962 7098 fax
linda.thomsen@davispolk.com

July 21, 2015

Re: In the Matter of Citigroup Global Markets, Inc. (HO-11492); In the Matter of Citigroup Global Markets, Inc. and Morgan Stanley Smith Barney LLC, Certain Principal Transactions (H0-11569)

Via Electronic Mail and Hand Delivery

Mary J. Kosterlitz, Esq.
Chief, Office of Enforcement Liaison
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Dear Ms. Kosterlitz:

We submit this letter on behalf of our client, Citigroup Inc. ("Citigroup"), in connection with the settlement of the above referenced administrative proceeding by the Securities and Exchange Commission (the "Commission") against Citigroup Global Markets Inc. ("CGMI"), a broker-dealer and wholly-owned subsidiary of Citigroup.

Pursuant to Rule 405 promulgated under the Securities Act of 1933, as amended (the "Securities Act"), Citigroup hereby respectfully requests that the Director of the Division of Corporation Finance, pursuant to the delegation of authority of the Commission,[1] determine that for good cause shown it is not necessary under the circumstances that Citigroup be considered an "ineligible issuer" under Rule 405. Citigroup requests that this determination be effective upon the entry of an order against CGMI in the above-captioned matter (the "Order").

Background

The Enforcement Staff has engaged in settlement discussions with CGMI in connection with the above-captioned administrative proceeding and has determined that CGMI has violated

[1] 17 C.F.R. § 200.30-1(a)(10).

Section 15(g) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-7 thereunder. Without admitting or denying the findings included in the Order, except as to the Commission's jurisdiction over it and the subject matter of the proceedings, CGMI has consented to the entry of the Order, which institutes administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act and imposes remedial actions.

As set forth in the Order , the Enforcement Staff has found that, for a period of approximately two and a half years, certain advisory orders were inadvertently routed to one of CGMI's affiliated market makers, Automated Trading Desk Financial Services LLC ("ATD"), on a principal basis. CGMI's policies and procedures should not have allowed these orders to be routed to ATD and executed on a principal basis, and CGMI's trade surveillance did not detect that principal transactions were being executed through ATD. This conduct is the basis for the Enforcement Staff's determination that CGMI has violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. In addition to resolving this issue, CGMI has voluntarily disgorged all profits realized from the principal transactions executed by ATD, resulting in customer remediation in the amount of $2.5 million.

The Order also sets forth the Enforcement Staff's basis for its determination that CGMI has violated Section 15(g) of the Exchange Act. The Enforcement Staff has found that, for a number of years, monitoring of CGMI's trading, including proprietary trading, was partially ineffective because it did not monitor a portion of the trades executed by certain of its trading desks. Due to certain technical errors, the electronic trade reports that CGMI personnel used for daily surveillance of trading against its Loan Watch List and Restricted Trading List were missing data concerning relevant trades executed on certain trading platforms. CGMI has repaired the reports to capture the missing data and has voluntarily retained a consultant to conduct a comprehensive review of CGMI's Information Barrier Surveillance Group ("IBSG") practices.

Pursuant to the Order, CGMI will be censured and will pay a civil monetary penalty in the amount of $15 million. CGMI also will be ordered to comply with an undertaking to retain or continue to retain a consultant to conduct a comprehensive assessment of CGMI's trade surveillance program and order handling in relation to transactions for which CGMI acts as an investment adviser.

Citigroup is a publicly traded company listed on the New York Stock Exchange and is a reporting company under the Exchange Act. Citigroup has identified itself in filings with the Commission as a well-known seasoned issuer ("WKSI"). CGMI is registered as an investment adviser under the Investment Advisers Act of 1940 and as a broker-dealer under the Exchange Act. Citigroup is the only issuer that is a parent of CGMI.

Discussion

A WKSI is a category of issuer created under Rule 405 that is eligible for significant securities offering reforms adopted by the Commission in 2005 that have changed the way

corporate finance transactions for larger issuers are planned, brought to market and executed.[2] At the same time, the Commission created another category of issuer under Rule 405, the "ineligible issuer." Rule 405 deems an issuer ineligible when, among other things, "[w]ithin the past three years . . . the issuer or any entity that at the time was a subsidiary of the issuer was made the subject of any judicial or administrative decree or order arising out of a governmental action that . . . prohibits certain conduct or activities regarding, including future violations of, the anti-fraud provisions of the federal securities laws . . . ." or that determines that there has been a violation of the anti-fraud provisions of the federal securities laws. An ineligible issuer is excluded from the category of "well-known seasoned issuer" and is thus prohibited from taking advantage of the significant securities offering reforms referred to above.

In our memorandum dated October 10, 2014 (attached as Exhibit A), we submitted that this case does not involve a violation of the anti-fraud provisions of the federal securities laws. We noted that the violations charged in the Order – namely, Section 15(g) of the Exchange Act and Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder – do not constitute fraud or any other scienter-based violation. Instead, the violations charged in the Order all relate to requirements to have and implement reasonable written policies and procedures. More specifically, Section 15(g) is not itself an anti-fraud provision of the federal securities laws (or a basis for ineligibility under Rule 405), but a provision that affirmatively requires that every broker and dealer "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." Similarly, Rule 206(4)-7 requires that every investment adviser "adopt and implement written policies and procedures reasonably designed to prevent violation, by [the adviser] and [its] supervised persons, of the [Advisers] Act and the rules that the Commission has adopted under the [Advisers] Act." Rule 206(4)-7 is the functional equivalent of Section 15(g) in requiring appropriate policies and procedures, albeit with a different focus, and does not seek to address fraudulent behavior.

The Staff did not agree with these arguments, and, therefore, entry of the Order would make Citigroup an ineligible issuer under Rule 405.

Securities Act Rule 405 authorizes the Commission to determine, "upon a showing of good cause, that it is not necessary under the circumstances that the issuer be considered an ineligible issuer." As noted above, the Commission has delegated the function of granting or denying such applications to the Director of the Division of Corporation Finance, whose assessment "focuses on how the conduct that gave rise to the ineligibility relates to the reliability of the issuer's current and future disclosure, and if it does, what steps the issuer has taken to remediate any deficiencies."[3]

---

[2] See Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,790 (Aug. 3, 2005).

[3] Division of Corporate Finance "Revised Statement on Well-Known Seasoned Issuer Waivers," April 24, 2014.

REASONS FOR GRANTING A WAIVER

Under the facts and circumstances of this action and considering the alleged conduct involved as described in the Order, Citigroup respectfully submits that granting Citigroup a waiver from ineligible issuer status is in the public interest and that declaring Citigroup to be an ineligible issuer is not necessary for the protection of investors. In making this request, Citigroup has carefully considered the policy statement on the framework for well-known seasoned issuer waivers[4] and, as discussed in more detail below, believes that the granting of the waiver request would be consistent with the policy statement.

Responsibility For and Duration of the Misconduct

The alleged conduct addressed in the Order does not pertain to activities undertaken by Citigroup in connection with Citigroup's role as an issuer of securities (or any disclosure related thereto). No conduct by Citigroup and no conduct in respect of Citigroup's disclosures (or for that matter, any public disclosures) is implicated. No employees of Citigroup are named as respondents in the proceeding, and the Commission does not allege that any of the directors or senior management of Citigroup engaged in any deliberate misconduct or were aware of violative conduct or ignored any warning signs or "red flags" regarding the conduct. The Order does not find that Citigroup's disclosure controls and procedures or filings with the Commission during this time period were deficient.

Rather, the alleged conduct involved non-scienter-based conduct at the subsidiary level, without involvement by Citigroup. In this regard, the Order concerns certain technological errors that caused CGMI's surveillance for trading in violation of legal requirements and firm policies to be partially ineffective. As noted above, the violations charged in the Order relate to requirements to have and implement reasonable written policies and procedures, not to public disclosures or any willful violation.

As described in the Order, CGMI's inadvertent routing of transactions on behalf of advisory clients to ATD occurred from approximately October 2007 through February 2010. However, the incidence of managed account orders routed to ATD diminished markedly as a result of systems improvements that CGMI introduced in July 2008, such that 90% of the misrouted orders preceded July 2008, and only 10% took place during the period between August 2008 and February 2010.[5]

---

[4] *Id.*

[5] The technological errors giving rise to the Enforcement Staff's determination that CGMI violated Section 15(g) of the Exchange Act continued for various periods of time. CGMI's inadvertent exclusion of non-loan trades from its LoansQT data feed and, consequently, its surveillance for trading against the Loan Watch List, began in 2002 and was repaired in 2009. CGMI's omission of certain data from the reports used to monitor compliance with the Restricted Trading List ("RTL") began in early 2009 and was repaired in early 2012. During the time that these surveillance reports were missing data, CGMI used a number of other surveillances to monitor for potential misuse of material non-public information and other violations of law, including event-driven deal reviews and other bespoke lookback reviews, surveillance of firm and personal trading by employees designated "over-the-wall," pre-clearance requirements, and daily surveillance reports covering employees' personal trading activity

Remedial Steps

Since 2010, CGMI has cooperated with the Division of Enforcement's investigations that resulted in the above-captioned matter. CGMI has taken steps to address the trade surveillance technological errors that were the source of the violations discussed in the Order and to ensure that the violative conduct alleged in the Complaint does not recur. Each of these technological issues were repaired more than two years before the date of the Order. In addition, CGMI voluntarily retained a consultant to conduct a comprehensive review of its IBSG practices and to recommend improvements to CGMI's surveillance practices and the technology used to implement its trade surveillance.

Further, the Order requires that CGMI comply with certain undertakings which require, among other things: (i) CGMI to retain a consultant, or continue to retain its current consultant, to conduct a review of CGMI's current surveillance program, including its implementation and enforcement of trade surveillance policies and procedures, its surveillance report development, process of applications, change management processes and procedures, and its use of the Loan Watch List and RTL; (ii) CGMI to retain a consultant, or continue to retain its current consultant, to conduct a review of CGMI's policies and procedures concerning the handling and routing of advisory orders; (iii) the consultant(s) to prepare a written report that evaluates the areas reviewed and provides recommendations about how CGMI should modify or supplement its trade surveillance policies and procedures and advisory account order handling and routing policies and procedures and the implementation and enforcement of such procedures; (iv) CGMI to take all necessary and appropriate steps to adopt the consultant(s) recommendations; and (v) CGMI to certify, in writing, compliance with the undertakings. CGMI has already retained a consultant to conduct a review of its current surveillance program and such review is substantially complete.

As the Staff is aware, Citigroup has previously requested waivers regarding its WKSI status from the Division of Corporation Finance in connection with settlements involving CGMI. Waivers have previously been requested and granted concerning (a) CGMI's settlement with the Commission on May 31, 2006 in connection with the marketing and sale of auction rate securities; (b) CGMI's settlement with the Commission on December 23, 2008 in connection with the marketing and sale of auction rate securities; (c) CGMI's settlement with the Commission on September 26, 2014 in connection with its 2007 marketing of a collateralized debt obligation ("CDO") structured by CGMI; (d) Citicorp's entry of a plea agreement with the United States Department of Justice on May 20, 2015 in connection with an antitrust violation arising from the behavior of an FX trader; and (e) CGMI's settlement with the Commission on June 18, 2015 in connection with its self-reported failures to conduct adequate due diligence when underwriting certain municipal securities offerings. Like the alleged conduct at issue here, none of the alleged conduct at issue in those matters related to Citigroup's own disclosures, and instead concerned CGMI's obligations as an underwriter and marketing for and disclosure relating to specific types of financial products. These past matters do not in any way relate to the conduct at issue here, which concerns partially ineffective trade surveillance due to technological errors.

A prior settlement, in 2010, involved the reliability of Citigroup's disclosures. There, Citigroup itself (not CGMI) entered into a settlement with the Commission in connection with alleged material misstatements in disclosures filed with the Commission about exposure to sub-

prime mortgages.[6] As a result, Citigroup was deemed an ineligible issuer, and lost its WKSI status. In connection with this settlement, Citigroup agreed to comply with certain undertakings, all of which were already in place at the time of the settlement, related to its policies, practices, and procedures concerning the disclosure of its earnings and other information related to its financial performance in quarterly press releases, including (i) maintaining a Disclosure Committee and a set of controls and procedures for that committee; (ii) maintaining an Earnings Subcommittee of the Disclosure Committee; (iii) requiring certain individuals to sign and date Statements of Accountability prior to release of Citigroup's quarterly earnings information; and (iv) quarterly execution by the Disclosure Committee of a certification regarding the effectiveness of Citigroup's disclosure controls and procedures. These practices and policies remain in place and Citigroup regained WKSI status in late 2013 at the end of the three-year period specified in Securities Act Rule 405.

In sum, CGMI has consistently implemented remedial measures to protect against conduct for which it has been sanctioned before the regulatory action relating to such conduct has become final. The alleged conduct at issue in the Order does not call into question the adequacy of Citigroup's disclosures or the efficacy of its disclosure controls and procedures, now or in the future.

These facts support a clear conclusion that Citigroup can demonstrate and has demonstrated that ineligible issuer status is not necessary for the public interest or the protection of investors because, particularly in light of the nature of the conduct described in the Order, the conduct giving rise to the ineligibility in no way calls into question the reliability of Citigroup's current and future disclosures. Further, the alleged conduct at issue here in no way suggests that Citigroup affiliates did not adequately implement remedial steps in other, earlier settlements involving other businesses and other products. All of the facts support a conclusion that the granting of a waiver would be entirely consistent with the guidelines for relief established in the framework most recently published by the Division of Corporation Finance.

Impact on Issuer

The Order is the result of substantial negotiations between CGMI and the Enforcement Staff. Its terms have been carefully crafted to meet and balance the competing concerns of all involved. The Order censures CGMI, requires its payment of a civil monetary penalty and completion of an undertaking, and orders it to cease and desist from committing or causing any violations and any future violations of Section 15(g) of the Exchange Act, and Section, 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. Determining to maintain ineligible issuer status for Citigroup would, in effect, impose a sanction that would go well beyond the agreed-upon settlement terms negotiated by CGMI in good faith, and that would be disproportionately severe given the nature of the non-scienter-based violations that are the subject of the action, including the lack of any nexus to Citigroup's public disclosures (or any other public disclosures), and the duration of time that has passed since the relevant events.

As the Staff is aware, Citigroup is a frequent issuer of securities that are registered with the Commission and offered and sold under its current Form S-3 registration statement (the

[6] See Securities and Exchange Commission v. Citigroup Inc., 1:10-cv-01277 (D.D.C. Oct. 19, 2010).

"WKSI shelf"). Since November 2013, Citigroup has issued a variety of securities that are registered under the WKSI shelf, including unsecured senior or subordinated debt securities and preferred stock and related depositary shares, and has the ability to issue its common stock, common stock warrants, index warrants, stock purchase contracts, and stock purchase units off the WKSI shelf. Since regaining its WKSI status in November 2013, Citigroup has issued off the WKSI shelf approximately $7.2 billion of regulatory capital securities (in the form of preferred stock represented by depositary shares), approximately 52% of all regulatory capital securities issued by Citigroup in that period. In that same period, the value of all securities issued by Citigroup off the WKSI shelf was approximately $38.5 billion in over 400 offerings. These figures demonstrate the importance of the WKSI shelf to Citigroup in meeting its capital, funding and regulatory requirements.

In connection with those 400+ public offerings, Citigroup utilized approximately 190 free writing prospectuses ("FWPs"), more than half for offerings of structured notes under Citigroup's medium-term note ("MTN") program. Approximately 45% of these MTN FWPs consisted of marketing materials that could not be used by an ineligible issuer without modification. Moreover, many of Citigroup's MTN offerings are distributed through third-party distributors. These distributors often produce their own MTN FWPs and may object to being limited only to those FWPs available to ineligible issuers. This limitation may cause third-party distributors to no longer offer Citigroup MTNs to their clients, significantly limiting this source of funding for Citigroup.

As an ineligible issuer, Citigroup would lose significant flexibility, most importantly the ability to register additional types of securities not covered by the WKSI shelf by filing a new registration statement or post-effective amendment that becomes immediately effective. The adverse market and issuer impact of the potential loss of flexibility with respect to new types of securities is particularly important to Citigroup in light of regulatory and market conditions and uncertainties that are significantly transforming the landscape for financial institutions like Citigroup. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Financial Reform Act"), the Board of Governors of the Federal Reserve System (the "Federal Reserve") has imposed, and has the authority to impose further, prudential standards on financial institutions. These standards include new rules relating to heightened capital, leverage and liquidity standards; many of these rules have only been recently finalized. Moreover, these new rules allow the U.S. bank regulators to impose "counter-cyclical" capital buffers at any time based "on a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk," and certain of these regulators have indicated they are considering higher capital buffers for institutions like Citigroup. Based on the final U.S. capital rules, adopted as recently as September 2014, the capital requirements for institutions such as Citigroup have been enhanced as of January 1, 2014, and will continue to be raised significantly through a phase that will last through 2018. In addition, over the next few years, the U.S. bank regulators and certain international bodies, such as the Financial Stability Board, are expected to recommend or impose further capital, liquidity, or similar requirements on institutions such as Citigroup (e.g., "total loss absorbing capacity," or TLAC), the outlines and impacts of which are not fully known.

Finally, under the annual stress tests administered by the Federal Reserve, the parameters and requirements of which change annually, significant capital buffers, above the regulatory minimum levels, are required for financial institutions to be able to withstand a severe

economic downturn hypothesized by the Federal Reserve for purposes of the stress tests. The results of the stress tests can further dictate additional capital needs. Although qualifying regulatory capital currently generally consists of common equity, preferred equity and certain subordinated debt, given all of the recent and potential future changes to Citigroup's capital, liquidity, and similar requirements, it is likely that capital raising efforts going forward will involve the issuance of new types of securities. Implementation of a buffer requirement and uncertainty as to its design, as well as the other potential capital needs described above, could impose additional needs on Citigroup to access the capital markets, including through the use of securities with characteristics that are not yet known and therefore are difficult to anticipate in a shelf registration statement. "File and launch" for the public offering of new securities has developed as the market standard for large issuers since the advent of the Commission's securities offering reform in 2005. By the time Citigroup may be able to enter the market (*i.e.*, after it files an amendment to its non-WKSI shelf registration statement subject to staff review and approval), the market could be saturated, there may not be the same level of demand or pricing terms may have become disadvantageous.

* * *

In sum, Citigroup respectfully submits that, based on the factors set forth in the framework, the loss to Citigroup of certainty and flexibility if it were to become an ineligible issuer would be a disproportionate hardship in light of the nature of the alleged conduct which is the subject of the Order. More importantly, because the alleged conduct at issue in this matter in no way relates to Citigroup's ability to produce reliable disclosures, including in its role as an issuer of securities, granting a waiver in this instance is consistent with the public interest and the protection of investors. We respectfully request that the Director of the Division of Corporation Finance make that determination.

Please do not hesitate to call me at the above number should you have any questions. Thank you for your consideration.

Very truly yours,

Linda Chatman Thomsen

cc: Robert Cohen, SEC Division of Enforcement
Anthony Kelly, SEC Division of Enforcement
Joshua E. Levine, Citigroup Inc.

Exhibit A

MEMORANDUM

Morgan Lewis
COUNSELORS AT LAW

FOIA CONFIDENTIAL TREATMENT REQUESTED

Via Email and U.S. Mail

TO: Douglas J. Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission

FROM: Christian J. Mixter
Steven W. Stone
Morgan, Lewis & Bockius LLP

DATE: October 10, 2014

SUBJECT: Status of Section 206(4) and Rule 206(4)-7 as "Anti-Fraud Provisions" for Purposes of Rule 405

On behalf of our clients Citigroup Inc. ("Citigroup") and Citigroup Global Markets Inc. ("CGMI"), we submit this memorandum to set forth more fully the reasons why the settlement of *In the Matter of Citigroup Global Markets, Inc. and Morgan Stanley Smith Barney LLC, Certain Principal Transactions* (HO-11569) that is currently under consideration by the Enforcement Staff and CGMI should not trigger the "ineligible issuer" provisions of Rule 405 promulgated under the Securities Act of 1933, as amended (the "Securities Act").

The Parties' Proposed Settlement

Citigroup is a publicly traded company listed on the New York Stock Exchange and is a reporting company under the Securities Exchange Act of 1934 (the "Exchange Act"). Citigroup's subsidiary, CGMI, is registered as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act") and as a broker-dealer under the Exchange Act. The Enforcement Staff has engaged in simultaneous settlement discussions with CGMI in connection with HO-11569 as well as another investigation captioned *In the Matter of Citigroup Global Markets, Inc.* (HO-11492). With respect to HO-11492, the Enforcement Staff has found that, for a number of years, monitoring of CGMI's principal trading was partially ineffective because CGMI did not monitor a portion of the trades executed by certain of its trading desks. Due to certain technical errors, the electronic trade reports that CGMI personnel used for daily surveillance of trading against its Loan Watch List and Restricted Trading List were missing data concerning relevant trades executed on certain trading platforms. The Staff has concluded that CGMI thereby violated Section 15(g) of the Exchange Act. CGMI has repaired the reports to capture the missing data and has voluntarily retained a consultant to conduct a comprehensive review of CGMI's Information Barrier Surveillance Group ("IBSG") practices.

With respect to HO-11569, the Enforcement Staff has found that, for a period of approximately two and a half years, certain advisory orders were inadvertently executed by one of CGMI's affiliated market makers, Automated Trading Desk Financial Services LLC ("ATD"), on a principal basis. CGMI has voluntarily disgorged all profits realized from the principal transactions executed by ATD, resulting in customer remediation in the amount of $2.5 million, and has improved its procedures. Recognizing the inadvertence of the trades themselves and in light of CGMI's voluntary remediation of them, the Enforcement Staff has not drafted the proposed Order to charge CGMI with improper trading on a principal basis. Rather, the Order charges CGMI with a lack of adequate procedures and surveillance. Specifically, the Order states that CGMI's procedures should have prevented the subject orders from being executed by ATD on a principal basis, and that CGMI's trade surveillance should have, but did not, detect that principal transactions were being executed through ATD, in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The violations of Section 206(4) that the Order charges arise solely from the charged violations of Rule 206(4)-7 concerning procedures.

In addition to making the foregoing findings and ordering CGMI to cease and desist from further violations of Section 15(g), Section 206(4), and Rule 206(4)-7, the proposed Order would censure CGMI and direct CGMI to pay a civil monetary penalty in the amount of $15 million. CGMI also will be ordered to comply with an undertaking to retain or continue to retain a consultant to conduct a comprehensive assessment of CGMI's trade surveillance program and order handling in relation to transactions for which CGMI acts as an investment adviser.

Citgroup's Status as a WKSI

CGMI's parent Citigroup has identified itself in filings with the Commission as a well-known seasoned issuer ("WKSI"), as defined in Rule 405. A WKSI is a category of issuer created under Rule 405 that is eligible for significant securities offering reforms adopted by the Commission in 2005 that have changed the way corporate finance transactions for larger issuers are planned, brought to market and executed.[1] At the same time, the Commission created another category of issuer under Rule 405, the "ineligible issuer." Rule 405 deems an issuer ineligible when, among other things, "[w]ithin the past three years . . . the issuer or any entity that at the time was a subsidiary of the issuer was made the subject of any judicial or administrative decree or order arising out of a governmental action that . . . prohibits certain conduct or activities regarding, including future violations of, the anti-fraud provisions of the federal securities laws . . . ." or that determines that there has been a violation of the anti-fraud provisions of the federal securities laws. An ineligible issuer is excluded from the category of "well-known seasoned issuer" and is thus prohibited from taking advantage of the significant securities offering reforms referred to above.

There is no dispute that Section 15(g) of the Exchange Act is not an anti-fraud provision. Thus, to the extent that the proposed Order finds violations of Section 15(g) and orders CGMI to cease and desist from further violations of that section, it would not make Citigroup an ineligible issuer under Rule 405. We submit that the same result should apply with respect to the findings and order pursuant to Section 206(4) and Rule 206(4)-7. This memorandum is directed at

[1] *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,790 (Aug. 3, 2005).

demonstrating that ineligible issuer status should not flow from the Section 206(4)/Rule 206(4)-7 violations at issue in this case because Rule 206(4)-7 is not an anti-fraud provision and because Section 206(4), when triggered by a violation of Rule 206(4)-7 or a similar rule, also is not an anti-fraud provision.[2]

Section 206(4): The Relevant Language Grants Authority to Issue Prophylactic Rules

The text of Section 206(4) is significant:

> Sec. 206. It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> > (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

By its plain language, Section 206(4) does three things: it prohibits fraudulent, deceptive, or manipulative acts, practices, and courses of business, and it grants the Commission two types of rulemaking authority: authority to *define* fraudulent, deceptive, or manipulative acts, practices, and courses of business; and authority to prescribe means reasonably designed to *prevent* fraudulent, deceptive, or manipulative acts, practices, and courses of business. The latter type of rule is commonly referred to as a "prophylactic" rule. In the words of the Supreme Court, "[a] prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited." *United States v. O'Hagan,* 521 U.S. 642, 672-73 (1997). Put another way, Congress' grant to the Commission of authority to regulate non-fraudulent activities as a means to prevent fraud does not mean that a violation of such regulations itself becomes fraudulent. *Cf. Schreiber v. Burlington Northern, Inc.*, 472 U. S. 1, 12 n.11 (1985) (stating that Section 14(e) gives the "Commission latitude to regulate nondeceptive activities as a reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself."). Thus, the fact that Rule 206(4)-7 was issued – in part[3] –

---

[2] We are aware that Securities Act Rule 405 authorizes the Commission to determine, "upon a showing of good cause, that it is not necessary under the circumstances that the issuer be considered an ineligible issuer," and that CGMI could apply for such a waiver to the Director of the Division of Corporation Finance, pursuant to delegated authority. Division of Corporation Finance, "Revised Statement on Well-Known Seasoned Issuer Waivers," April 24, 2014. However, we also are aware that the Division of Corporation Finance prefers not to consider waiver applications that are based on hypothetical facts (such as a settling party's ability to engage in a business in which it is not, in fact, engaged), and would expect that preference to extend to waiver applications that are not required by law (such as a request for a WKSI waiver premised on an order that does not implicate the anti-fraud provisions).

[3] Rule 206(4)-7 is grounded not only in Section 206(4), but also in Section 211(a), the general grant of rulemaking authority under the Advisers Act.

under authority of a statute that permits the Commission to issue rules prescribing means "reasonably designed to prevent" fraud does not mean that a violation of Rule 206(4)-7 *is* fraud.

The distinction between rules that define fraud and prophylactic rules is not merely theoretical. The Commission has made use of both types of rulemaking authority that Congress granted in Section 206(4), promulgating a number of rules that *define* fraud for purposes of the statute (by declaring certain practices to "constitute" fraud),[4] and a number of other rules that prescribe means reasonably designed to *prevent* fraud (by declaring violations of those rules to be "unlawful").[5] Such differences in wording – between anti-fraud rules that define what "constitutes" fraud on the one hand, and prophylactic rules, disobedience of which is "unlawful" on the other hand – must be accorded meaning. It is a common canon of statutory construction that "[w]here Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. United States*, 464 U.S. 16, 23 (1983); *see also Bates v. United States*, 522 U.S. 23, 29 (1997) (refusing to find "intent to defraud" language in one provision when it is explicitly included in a parallel provision). A court must set an agency's interpretation aside if the plain language of the regulation requires another interpretation. *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994). The same canons apply to agency rules such as Rule 206(4)-7 and other rules where the SEC has chosen language that differentiates between defining fraud and prescribing means to prevent fraud.[6]

Rule 206(4)-7: The Commission Has Stated That It Is Not an Anti-Fraud Provision

The history of Rule 206(4)-7 shows that the Commission consciously intended it not to be, or to have the effects of, an anti-fraud provision. When they were proposed in February 2003, Rule 206(4)-7 and its contemporary, Rule 38a-1 under the Investment Company Act of 1940 ("Investment Company Act"), were plainly described as "Proposed Rules [that] would

[4] *See* Rule 206(4)-1(Advertisements by investment advisers; deeming rule violations as constituting a "fraudulent, deceptive, or manipulative act, practice, or course of business"); Rule 206(4)-2 (Custody of funds or securities of clients by investment advisers; deeming rule violations as constituting a "fraudulent, deceptive, or manipulative act, practice, or course of business"): Rule 206(4)-4 (Financial and disciplinary information that investment advisers must disclose to clients (withdrawn); deeming rule violations as constituting a "fraudulent, deceptive, or manipulative act, practice, or course of business"): Rule 206(4)-6 (Proxy voting; deeming rule violations as constituting a "fraudulent, deceptive, or manipulative act, practice, or course of business"); Rule 206(4)-8 (Pooled investment vehicles; deeming rule violations as constituting a "fraudulent, deceptive, or manipulative act, practice, or course of business").

[5] *See* Rule 206(4)-3 (Cash payments for client solicitations; deeming rule violations as "unlawful"); Rule 206(4)-5 (Political contributions by certain investment advisers; deeming rule violations as "unlawful"); Rule 206(4)-7 (Compliance procedures and practices; deeming rule violations as "unlawful" within the meaning of section 206).

[6] Courts reviewing agency rules and regulations often use principles of statutory interpretation to construe agency rules. *See e.g., Rucker v. Wabash R. Co.*, 418 F.2d 146, 149 (7th Cir. 1969) ("Administrative regulations, like statutes, must be construed by courts, and the same rules of interpretation are applicable in both cases."). The D.C. Circuit, in particular, uses rules of statutory construction when interpreting regulations. *See Fabi Constr. Co. v. Sec'y of Labor*, 508 F.3d 1077, 1087 (D.C. Cir. 2007) (relying on *noscitur a sociis* as part of determination that the plain meaning of "formwork" precludes the agency's interpretation of the regulation); *Sec'y of Labor v. Twentymile Coal Co.*, 411 F.3d 256, 260–61 (D.C. Cir. 2005) (applying the canon against absurdity when holding "[t]o read the regulation's use of the term . . . [in this way] would lead to absurd results . . . This Court will not adopt an interpretation of a statute or regulation when such an interpretation would render the particular law meaningless.").

require funds and advisers to adopt and implement policies and procedures reasonably designed to *prevent* violation of the federal securities laws"[7] – precisely the type of prophylactic rules described in *O'Hagan* and *Schreiber*. The initial language proposed for Rule 206(4)-7, however, contained a very illuminating mistake: it began with words that, rather than prescribing means designed to *prevent* fraud, instead would have *defined* the absence of the required procedures as fraud:

> If you are an investment adviser registered or required to be registered under section 203 of the Investment Advisers Act of 1940 (15 U.S. C. 80b-3), it is a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for you to provide investment advice to clients unless . . . . [8]

No fewer than eight commenters on the proposed rules pointed out this mistake.[9] The arguments offered by the commenters included concerns based on fairness, for example the following:

> Indeed, it appears that it might be considered a fraudulent practice where written policies and procedures are found lacking, and yet the investment adviser has not otherwise violated any applicable laws and regulation. This aspect of the new rule is particularly troubling if enforcement proceedings can and will be brought solely on allegations that a particular policy or procedure is considered deficient. Conceivably, diligent investment advisers who proactively try to develop new policies and procedures but come up short, might put their firms at greater enforcement risk than other advisers who might overlook, defer or otherwise not bring attention to a particular aspect of their business.[10]

Another commenter pointed out both the unfairness and disproportionality of declaring a lack of procedures as fraud and the untoward collateral consequences of doing so:

> We believe that good compliance is essentially part of the supervisory obligation that is already imposed by law on advisory firms. It seems unfair to mischaracterize a policy drafting decision or breakdown in proper supervision as a fraud. For example, suppose an adviser erroneously charged a client a performance-based fee in violation of Section 205 of the Advisers Act. Also suppose that the proposed rules were adopted and the

[7] "Compliance Programs of Investment Companies and Investment Advisers," Release Nos. IC-25925, IA-2107 at 4-5 (February 5, 2003) ("Rule 206(4)-7 Proposing Release") (emphasis added), *available at* http://www.sec.gov/rules/proposed/ic-25925.htm , 68 Fed. Reg. 7038 (Feb. 11, 2003).

[8] *Id.* at 21.

[9] *See* Summary of Comments on Proposed New Rules 38a-1 Under the Investment Company Act and 206(4)-7 under the Investment Advisers Act, and Proposed Amendments to Rule 204-2 Under the Investment Advisers Act, at 14 & n. 59, *available at* http://www.sec.gov/rules/extra/s70303summary.pdf (Nov. 20, 2003), citing comment letters submitted by Brown & Associates and Self Audit, Inc., Financial Engines Advisors LLC, Investment Counsel Association of America, Inc., National Society of Compliance Professionals, Pickard & Djinis LLP, Charles Schwab & Co., Inc. and Charles Schwab Investment Management, Inc., T. Rowe Price Associates, Inc., and Vanguard Group.

[10] Comment Letter from Financial Engines Advisors LLC at 2 (April 18, 2003), *available at* http://www.sec.gov/rules/proposed/s70303/financial041803.htm.

> advisory firm failed to include what the Commission deemed to be an adequate discussion of the rules governing performance-based fees in its compliance manual. It seems fundamentally unfair to charge the firm with a violation of Section 205 for erroneously charging the fee and to add a potentially much more serious fraud charge based on the defect in the compliance manual.[25] We suggest that the defect in the compliance manual is better characterized as a defect in supervision, not as a fraud.
>
> In addition, characterizing policy and procedure inadequacies as a fraud may have serious insurance implications. Typical errors and omissions policy forms for advisers include an exclusion for fraud by the insured or its officers or directors. Insurers may attempt to defeat coverage where there is an allegation or finding of deficient policies and procedures under an anti-fraud rule. Indeed, under the wording of some policies, insurers may even attempt to refuse to defend the action, much less cover any judgment against the adviser. Such a result would not benefit investors.[11]

Picking up on the theme of collateral consequences, a third commenter pointed out that characterizing a lack of policies and procedures as fraud could subject a defendant firm to state debarment procedures (analogous to "ineligible issuer" status under Rule 405, a status which had not yet been invented when the comment was submitted in 2003):

> For example, an adverse fraud ruling against an adviser typically renders that adviser ineligible for hire by many pension funds and other large, institutional clients. Furthermore, under state blue sky laws, an SEC finding of fraudulent or deceptive conduct against an adviser might be relied upon in a state proceeding as grounds to deny, suspend, or revoke that entity's broker-dealer license. *See, e.g.* Illinois Securities Law of 1953, 815 Ill Comp. Stat. 5/8 E(1)(k).[12]

In response to these concerns, the Commission changed the language of Rule 206(4)-7, eliminating the statement that would have defined the absence of policies and procedures as "a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of section 206(4) of the Act" and substituting a statement that the absence of those policies and procedures is "unlawful within the meaning of Section 206 of the Act." The Commission described the change in the following way:

> *In response to several comments*, we revised the text of the rule so that a violation of the rule would be deemed to be "unlawful" rather than "a fraudulent, deceptive, or manipulative act, practice or course of business." *This change, which responds to*

---

[11] Comment Letter from Investment Counsel Association of America, Inc. at 6, *available at* http://www.sec.gov/rules/proposed/s70303/icaa041703.htm.. Footnote 25 to the passage quoted above added that "This is particularly unfair because the new 'fraud' violations would be part of the adviser's Form ADV disclosure. Such disclosure could mislead clients with respect to the gravity of the offense."

[12] Comment Letter from Pickard & Djinis LLP at 2& n. 2 (April 18, 2003), *available at* http://www.sec.gov/rules/proposed/s70303/pickard041803.htm

commenters' concerns regarding the optics of the rule, does not change its substance; failure to comply with its terms will result in a violation of Section 206(4) of the Act.[13]

There is, to be sure, some remaining confusion between the Commission's statement in the final rule text that a violation of Rule 206(4)-7 is unlawful "under Section 206" and its statement in the release that a violation of the Rule "will result in a violation of Section 206(4)." If one must choose, then the language of the Rule itself prevails over an agency interpretation that conflicts with that language. *See Thomas Jefferson Univ.* If the language of the Rule does prevail, then a violation of Rule 206(4)-7 cannot be a violation of an anti-fraud provision because Section 206, as a whole, is not such a provision; the statute contains, for example, both Section 206(1), which plainly is an anti-fraud provisions, and Section 206(3), which is not an anti-fraud provision.[14] However, no such choice is necessary because even if a violation of Rule 206(4)-7 is a violation of Section 206(4) in particular, it is such a violation only in the sense that Section 206(4) empowers the Commission to promulgate rules that must be obeyed by regulated entities irrespective of whether those rules are anti-fraud provisions (i.e., they define fraud) or are not anti-fraud provisions (i.e., they prescribe means reasonably designed to prevent fraud). Certainly a violation of Rule 206(4)-7 cannot be a violation of the first sentence of Section 206(4), which forbids "engag[ing] in any act, practice, or course of business which ***is*** fraudulent, deceptive, or manipulative," because, as shown above, Rule 206(4)-7 is a prophylactic rule that prescribes means reasonably designed to prevent fraud.

Rule 206(4)-7 is not, and never has been, an anti-fraud rule, and by authorizing it Section 206(4) is not an anti-fraud provision. Any other reading of the statute and the rule would recreate in this case every one of the issues raised by the commenters to proposed Rule 206(4)-7 quoted above, and supposedly heeded by the Commission in the final Rule.

Fairness: Rule 206(4)-7 Should Not Be Treated Differently from Analogous Rules

The securities laws are full of provisions requiring regulated entities to adopt policies and procedures aimed at various goals, including but not limited to the prevention of fraud. To our knowledge, apart from Section 206(4) and Rule 206(4)-7, the Staff has not viewed the failure to comply with such a procedural mandate as a violation of the anti-fraud provisions. The most

---

[13] "Final Rule: Compliance Programs of Investment Companies and Investment Advisers," Release Nos. IA-2204, IC-26299 at 4 n.11 (Dec. 17, 2003) ("Rule 206(4)-7 Adopting Release") (emphasis added), *available at* http://www.sec.gov/rules/final/ia-2204.htm. The Commission did not explain its use of the word "optics" in the Release. As demonstrated above, the concerns raised by the commenters went well beyond "optics" and included substantive points regarding the fairness, proportionality, and collateral consequences of defining a lack of policies and procedures as "fraud." In view of those comments, the only way in which the word "optics" makes sense, and is not disingenuous, is if the Commission was referring back to its original intent regarding Rule 206(4)-7 – namely, that the Rule all along was intended only to require "advisers to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws," Rule 206(4)-7 Proposing Release at 4-5, so that the change to prophylactic language indeed did not change the substance of the rule.

[14] *In the Matter of Marc N. Geman*, Release No. IA-1924 at 9, 74 S.E.C. Docket 852, 858, 2001 WL 124847, at *8 (February 14, 2001) ("Advisers Act Section 206(3) mandates that investment advisers make certain disclosures under specified circumstances. It can be violated without a showing of fraud. Whether PMC made the requisite disclosure or came within the exception provided in Section 206(3) is a separate matter from whether it defrauded its customers under Sections 206(1) and (2) and the other antifraud provisions charged.").

obvious illustration of this point occurs in this very case. The violations charged in the draft Order – namely, Section 15(g) of the Exchange Act and Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder – all relate to requirements to have and implement reasonable written policies and procedures. Section 15(g) affirmatively requires that every broker and dealer "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." Similarly, Rule 206(4)-7 requires that every investment adviser "adopt and implement written policies and procedures reasonably designed to prevent violation, by [the adviser] and [its] supervised persons, of the [Advisers] Act and the rules that the Commission has adopted under the [Advisers] Act." Rule 206(4)-7 is the functional equivalent of Section 15(g) in requiring appropriate policies and procedures, albeit with a different focus. No one views Section 15(g) as an anti-fraud provision; Rule 206(4)-7 and a related violation of Section 206(4) should be treated in the same way.

Other examples abound:

- Section 206(4) was patterned after Section 15(c)(2) of the Exchange Act, and yet the rules under Section 15(c)(2) have not been deemed to be anti-fraud rules unless they specifically defined conduct as fraud (as Rule 15c2-11 did until its amendment in 1991, when it became a rule aimed at preventing fraud[15]). In fact, we have found no WKSI waivers sought or granted for violations of any rules under Section 15(c)(2).
- Exchange Act Rule 105 was initially adopted as Rule 10b-21 under Section 10(b)) but is not treated as an anti-fraud rule for purposes of Rule 405.
- Rules under Exchange Act Regulation 14E were adopted under Section 14(e) but are not treated as anti-fraud rules.
- Advisers Act Section 204A also is not an anti-fraud provision, nor is Rule 204A-1, which requires that each adviser "establish, maintain and enforce a written code of ethics."
- Rule 38a-1 under the Investment Company Act was adopted alongside, and is functionally parallel to, Rule 206(4)-7. Rule 38a-1 was adopted under Section 38(a). Section 38(a) authorizes the Commission to "make ... such rules and regulations ... as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in [the Investment Company Act]." Neither Section 38(a) nor Rule 38a-1 is an anti-fraud provision or rule.

It is incongruous, and thus unfair, to treat Rule 206(4)-7 as an anti-fraud rule when noncompliance with analogous Exchange Act provisions, as well as Section 204A, Rule 204A-1, Section 38(a) and Rule 38a-1 would not be deemed anti-fraud provisions or rules. This is particularly so in the current case where there is no charge of any underlying anti-fraud provision, based on the Staff's conclusion that no such charge is warranted.

---

[15] *See* Exchange Act Release No. 29094, 56 Fed. Reg. 19,148 (April 17, 1991).

Proportionality

Echoing the observations in the Investment Counsel comment letter quoted at page 5 above, in the context of this case viewing Rule 206(4)-7 as an anti-fraud rule would lead to the anomalous result that a failure to have or implement policies and procedures to address principal trading would be a fraud, but the actual act of principal trading would not be a fraud. This is so because principal trading by an investment adviser without client consent is addressed by Section 206(3) of the Advisers Act which, as noted above, is not an anti-fraud provision.[16] And these are hardly the only examples of this anomaly, even within the ambit of Rule 206(4)-7 alone. Rule 206(4)-7 requires that an adviser adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act, whether they involve fraud or not. It is illogical to treat as a violation of an anti-fraud rule an adviser's failure to have procedures covering immaterial or non-fraudulent provisions of the Advisers Act. The only way to avoid such anomalies is to treat all the Section 206(4) rules that make conduct "unlawful" to *prevent* fraud – specifically, Rules 206(4)-3, 206(4)-5, and 206(4)-7 – not to be anti-fraud provisions, and to treat the remaining Section 206(4) rules, which *define* fraud, as anti-fraud provisions.

Collateral Consequences

Ignoring the differences among the Section 206(4) rules also would lead to untoward results in the realm of collateral consequences, as warned by the commenters on proposed Rule 206(4)-7 or, as here, in connection with "ineligible issuer" statues for a firm's parent company under Rule 405. There is nothing about the regulatory regime surrounding WKSIs that would suggest that a non-fraud violation of an SEC rule by an issuer (let alone one of the issuer's subsidiaries) should deprive the issuer's shareholders of the benefits of WKSI status. Yet that is precisely the illogical outcome that is threatened here.

Conclusion

In carrying out its regulatory responsibilities to determine what is, and what is not, an "anti-fraud provision" for purposes of Rule 405 within the realm of the Section 206(4) rules, the Staff should be guided by the Commission's own work in classifying those rules between those that define fraud and those that prescribe means to prevent fraud. This is not difficult to do, as the Commission has chosen language that permits those determinations to be made with precision. To do otherwise would ignore, for no reason, choices that the Commission itself has made and visit anomalous and unjust consequences on investment advisers, their parent companies, and the shareholders of the parents.[17]

---

[16] *In the Matter of Marc N. Geman.*

[17] We note that the Staff of the Division of Corporation Finance identified Section 206(4), but not Rule 206(4)-7, as an anti-fraud provision of the federal securities law when enumerating various provisions that are non-scienter based. *See* Division of Corporation Finance, Statement on Well-Known Seasoned Issuer Waivers (July 8, 2011). That policy statement was specifically superseded by Division of Corporation Finance, Revised Statement on Well-Known Seasoned Issuer Waivers (April 24, 2014), which does not classify Section 206(4) as an anti-fraud provision. Perhaps related to the temporary confusion created by the 2011 Staff statement, there have been a number of WKSI waivers granted in cases that contained charges under Section 206(4)-7. We note, however, that in each of those cases there were other charges in the settlement that plainly involved the anti-fraud provisions and thus would have necessitated WKSI relief.